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REPORT
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SECOND MONETARY POLICY REPORT FOR 1985

FROM THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

A REPORT

together with

MINORITY VIEWS

SUBMITTED PURSUANT TO PUBLIC LAW 95-523

OCTOBER 4 (legislative day, SEPTEMBER 30), 1985.—Ordered to be printed

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LETTER OF TRANSMITTAL

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC, ———, 1985.

Hon. GEORGE BUSH,
President of the U.S. Senate,
Washington, DC.

DEAR MR. PRESIDENT: Transmitted herewith is the Second Monetary Policy Report for 1985 on the Conduct of Monetary Policy, pursuant to Public Law 95-523 and oversight hearing held on July 18, 1985.

Sincerely yours,

JAKE GARN, *Chairman.*

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OCTOBER 4 (legislative day, SEPTEMBER 30), 1985.—Ordered to be printed

Mr. GARN, from the Committee on Banking, Housing, and Urban Affairs, submitted the following

REPORT

together with

MINORITY VIEWS

[Submitted pursuant to Public Law 95-523]

SECOND MONETARY POLICY REPORT FOR 1985

On July 16, 1985, the Committee on Banking, Housing, and Urban Affairs received this year's second "Monetary Policy Report to Congress Pursuant to the Full Employment and Balanced Growth Act of 1978" (Public Law 95-523) from the Board of Governors of the Federal Reserve System.

On July 18, 1985, Federal Reserve Board Chairman Paul A. Volcker, appeared before the Banking Committee to testify on that report and to outline the Federal Open Market Committee's [FOMC] future plans regarding monetary policy.

The committee also received written statements on the status of monetary policy from the following: Beryl W. Sprinkel, Chairman, Council of Economic Advisers; Manuel H. Johnson, Assistant Secretary (Economic Policy), U.S. Department of the Treasury; A. Gilbert Heebner, executive vice president, CoreStates Financial Corp.; and Benjamin M. Friedman, professor of economics, Harvard University.

MONETARY AGGREGATES

In February 1985, Chairman Volcker announced that the FOMC had adopted a target range of 4 to 7 percent for growth in the M1 monetary aggregate from the fourth quarter of 1984 through the fourth quarter of 1985. For the broader aggregates, the Fed Chairman announced target ranges of 6 to 9 percent for M2; 6 to 9.5 per-

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cent for M3; and 9 to 12 percent for the debt of domestic nonfinancial sectors.

Growth in the M1 aggregate through April of this year remained close to the upper boundary of the February target range, but in May and June, the aggregate's growth rate surged to an annualized 18.7 percent. During July and August rapid growth continued at a 15.8-percent rate. Over the first half of the year as a whole, M1's growth rate was 12.2 percent, and over the first 8 months it was 13.5 percent.

Growth in the broader aggregates was within, or only slightly above, their target ranges for the first half of 1985. According to the Fed's "Monetary Policy Report," through June, M2 grew at 9.3 percent; M3 at 8.2 percent; and debt at an estimated 12.7 percent.

Rapid M1 growth actually began during the final 2 months of 1984, and it followed a 6-month period—from June through October—when the aggregate grew at a rate of less than 3 percent.

In his statement to the committee, Dr. Heebner pointed out that bank reserves grew at a 16.5 percent annual rate from December 1984 to June 1985, thereby reminding the committee that rapid M1 growth was associated with parallel rapid growth in the aggregate over which the Fed has most direct control.

Given the condition of the economy coinciding with rapid growth in the M1 aggregate, Chairman Volcker told the committee on July 18 that the FOMC had voted to rebase the targets for growth in M1. Instead of using a base of the aggregate's average size in 1984's last quarter for targeted growth during the remainder of 1985, the Fed Chairman announced that the new base would be M1's average size during 1985's second quarter.

The Fed Chairman also announced that the target growth range during the remainder of 1985 would be widened to an annualized 3 to 8 percent from the previously announced 4 to 7 percent. CEA Chairman Sprinkel pointed out this is the widest target range ever adopted by the FOMC.

No change was made in the target growth ranges for the broader aggregates during the remainder of 1985. Table I shows the tentative growth ranges announced for all the targeted aggregates during 1986.

TABLE I.—1986 GROWTH RANGES

Aggregate	Growth range (percent)
M1	4 to 7
M2	6 to 9
M3	6 to 9
Debt	8 to 11

REBASING ANALYSIS

Taken together, the decisions to rebase M1 and set its target growth range at 3 to 8 percent over the next two quarters meant that the FOMC had chosen to seek a substantial slowing in M1 growth during the remainder of 1985, but not to seek a slowing suf-

ficient to bring the aggregate back within the target range announced in February.

All four written statements submitted to the committee subsequent to Chairman Volcker's testimony endorsed the rebasing of M1 to the second quarter of 1985, but there was not similar unanimity of opinion over the decision to widen the target range.

Chairman Sprinkel supported the decision to rebase the target range for M1 because he feared that attempting to slow money growth sufficiently to bring M1 back within the February target range would have been likely to cause an economic downturn. The CEA Chairman, however, criticized the width of the new target range because it could accommodate too much variability in the growth rate.

Dr. Heebner and Professor Friedman, on the other hand, supported the FOMC's decision to widen the target range for growth in the aggregate during the remainder of this year. Dr. Heebner said the widening was justified "given the uncertainties about velocity." Professor Friedman's view was that the wider swings in monetary growth rates that could occur within the broadened target would not be significant.

While Assistant Secretary Johnson supported the FOMC's decision to abandon the target range for M1 growth that had been announced in February, he criticized the repeated failure to hit targets and pointed out that, "since 1980 M1 has been outside the target range much more frequently than it has been within."

Professor Friedman argued that rapid M1 growth during the first half of 1985 "did little more than offset the sluggish growth in the latter half of 1984," and he pointed out that for the whole of the year ending in the second quarter of 1985, M1 increased by only 7.0 percent. He found further support for the Fed's decision not to tighten in the fact the broader aggregates were growing within, or only slightly above, their target ranges.

INTEREST RATES AND VELOCITY

Short-term market interest rates declined markedly from September of last year through January of this year, with the commercial paper rate falling from over 11 percent to below 8 percent. During this period, the Federal Reserve cut the discount rate twice: from 9 percent to 8½ percent in November 1984 and to 8 percent in December.

After a temporary rise during Februrary and early March, market rates resumed a downward trend, and the Federal Reserve reduced the discount rate to 7½ percent in May. Since early summer there has been little net change in rates.

Rapid M1 growth during the first half of 1985 was associated with a decline in measured M1 velocity at an annual rate of about 5 percent. Such a decline in velocity means that the amount of M1 held by the public increased faster than the public's spending on goods and services.

Lower interest rates clearly reduce the opportunity cost of holding cash balances with below-market yields, and Chairman Volcker suggested that the decline in velocity was largely a lagged response to the decline in interest rates during the latter part of 1984. He

further suggested that the tendency to hold relatively larger cash balances at lower interest rates has probably been increased by the availability of interest-bearing NOW and Super NOW accounts and by the fact that yields on these accounts tend to decline more slowly than market rates.

Assistant Secretary Johnson cautioned against always assuming, whenever interest rates and velocity are both declining, that it is the decline in rates that is causing the decline in velocity. The Treasury representative pointed out that it is also possible that interest rates might be declining because velocity and the overall level of economic activity are declining.

Chairman Sprinkel raised another question about the Fed Chairman's explanations for the decline in velocity. The Council Chairman pointed out that accelerated money growth has historically led to increased economic activity and higher inflation, but only after a lag. Chairman Sprinkel questioned whether the decline in measured velocity might merely be the result of the fact that economic activity and the inflation rate have not yet responded to the acceleration in money growth.

ECONOMIC ACTIVITY

Real gross national product [GNP] grew at a meager annual rate of only 0.3 percent in the first quarter of 1985 and at a somewhat improved annual rate of 2.0 percent during the second quarter. The drop in the unemployment rate to 7.0 percent in August, however, together with other economic indicators point to a recent strengthening in real growth.

In his July testimony, Chairman Volcker pointed to "the sluggishness of manufacturing output," in particular, as one of three reasons for the FOMC's decision not to seek to bring M1 back within the target growth range announced in February. As has already been noted, Chairman Sprinkel told the committee that such an effort would have been likely to cause an "economic downturn."

The Fed Chairman contrasted the relatively slow growth in production with the much faster rate of increase—over 6 percent during the second quarter—in domestic final sales. Two factors accounted for the discrepancy: a reduction in the rate of inventory accumulation and, most importantly, a continuing high level of imports to satisfy domestic demand.

Relatively slow economic growth during the first half of the year was accompanied by moderate inflation. Through June, producer prices rose at an annual rate of 1.4 percent and consumer prices rose at a rate of 3.7 percent. Chairman Volcker's formal statement cited "relatively well contained price pressures" as a second of the three reasons for why the FOMC had decided not to seek an abrupt slowing of M1 growth.

While the value of the dollar on foreign exchange markets has shown a strong upward trend since 1980, there have been temporary periods of decline in the currency's value. After peaking in late February of this year, the value of the dollar measured on a trade-weighted basis declined about 12 percent through August. Still, the dollar remained sufficiently strong for Chairman Volcker

to cite the high dollar as the third justification for the FOMC's decision not to tighten monetary policy.

The Fed Chairman also told the committee that the strong dollar along with relatively slow growth in the economies of our trading partners were primarily responsible for the Nation's large trade deficit.

ECONOMIC ANALYSIS

Chairman Sprinkel concluded that the slow economic growth during the first half of 1985 was "at least partially attributable" to the fact that M1 growth virtually stopped from June through October of 1984." His submission to the Committee included a chart to illustrate that historically such "sharp swings in money growth that last 5 or 6 months or more have a significant impact on economic activity."

Professor Friedman, however, differed with Chairman Sprinkel and told the committee that there is no evidence that 6-month variations in money growth rates of last year's magnitude affect the economy in any significant way.

Assistant Treasury Secretary Johnson concurred with the CEA Chairman that a good portion of the economic slowdown could be attributed to 1984's pause in money growth, but the Treasury representative also noted that strict monetarist theory would have predicted a quicker real sector response to the acceleration in money growth beginning late last year. He suggested that part of the explanation for the transition to slower economic growth was merely the maturing of the expansion.

Assistant Secretary Johnson also linked the decline in the dollar which began in February to the acceleration in money growth beginning a few months earlier. In an analysis of the dollar's value since 1980, the Assistant Secretary found that the value of the dollar had responded primarily to massive capital flows induced by changed economic policies:

> These massive flows have been induced by a generalized perception that the U.S. economy has found a new direction and offers significantly higher after-tax rates of return on productive investment. Some observers completely reverse these obvious lines of causation and argue that the U.S. budget deficit has driven up interest rates and pulled in foreign capital. Surely it must be obvious that this does not explain five years of dollar appreciation during which time budget deficit projections have risen and interest rates have fallen. Foreigners invest in the United States despite our budget deficits not because of them.

While improved long-term prospects for the U.S. economy have put upward pressure on the dollar's value over the last 5 years, Assistant Secretary Johnson also found that throughout the period countervailing downward pressure had been exerted on the currency's value whenever money growth accelerated sharply.

In a written response to a question submitted to Chairman Volcker after his appearance before the Committee, he disagreed

with Assistant Secretary Johnson's finding that the decline in the value of the dollar after February was a consequence of accelerated money growth. The Fed Chairman instead expressed the opinion that the dollar's decline resulted from "the downward movement of U.S. interest rates over the spring and early summer relative to rates in other countries."

Looking to the future, Fed Chairman Volcker, CEA Chairman Sprinkel, Treasury Assistant Secretary Johnson, and Dr. Heebner all predicted accelerating economic growth in the months ahead, and the Fed Chairman told the committee that the FOMC expected "sustained growth through 1986."

Assistant Secretary Johnson told the committee that:

> There has never been a speedup of monetary growth in the period since World War II of the duration and magnitude that has taken place since last October without some resulting pickup in economic activity.

Dr. Heebner pointed to lower interest rates as well as the acceleration in money growth in explaining his forecast of a pickup in economic activity.

Fed Chairman Volcker, CEA Chairman Sprinkel and Treasury Assistant Secretary Johnson, however, all expressed the opinion that, if money growth were to continue at recent rates for an extended period, the likely result would be accelerating inflation.

CONCLUSIONS

Pursuant to the requirement in the Full Employment and Balanced Growth Act for a report to the Senate by the Committee on Banking, Housing, and Urban Affairs stating its "views and recommendations" regarding the Federal Reserve's Monetary Policy Report, the committee finds:

> (1) Given the relatively slow growth of real GNP accompanying rapid monetary growth during the first half of 1985, the FOMC in July had little choice but to abandon the target announced in February for M1 growth from the fourth quarter of 1984 through the fourth quarter of 1985. To have attempted to slow M1 growth growth sufficiently to bring it back within the original target range would have run an unacceptable risk of turning an economic slowdown into an actual downturn.
>
> (2) The reasons for recent swings in monetary velocity are not yet completely clear. In the face of continued uncertainty over the future course of velocity, the least risky monetary policy would appear to continue to call for stable, moderate rates of growth in the monetary aggregates.
>
> To continue M1 growth for an extended period at recent rates would threaten an unacceptable acceleration in inflation.
>
> (3) While the FOMC's decision to rebase the 1985 M1 growth target is clearly understandable, the decision to widen the target growth range is not. The Federal Reserve gave little justification for this decision. The Banking Com-

mittee has repeatedly urged the Federal Reserve to narrow its target ranges so that financial markets will have a better understanding of the Fed's policy objectives.

The committee is glad to see that the FOMC narrowed the width of the ranges in its tentative targets for M1 and M3 growth during 1986.

(4) Sharp swings in monetary growth rates that approach a half year in duration may have a destabilizing impact on real growth rates. The slowdown in real growth during the first half of 1985 may well have been at least partly attributable to the lagged effect of a 5-month period of very slow money growth in mid-1984.

(5) The acceleration in money growth beginning in late 1984 may well have been a major contributor to the decline in the dollar's value beginning in February. However, while a decline in the dollar's value would help reduce the Nation's trade deficit over time, accelerated money growth should not be used to seek to force down the dollar's value, for the long-term result would be accelerating inflation.

MINORITY VIEWS OF MR. RIEGLE

I believe that the Federal Open Market Committee's decision to widen the M1 target growth range for the second half of 1985 is consistent with the need to maintain flexibility in light of current ambiguous economic conditions and uncertainty over the future course of velocity. These are the same circumstances which necessitated overshooting and rebasing the earlier announced M1 target. It is my view, however, that such unreliability of the M1 aggregate should lead to its further deemphasis by the FOMC in preference for explicit targeting of annual, nominal GNP growth.

Furthermore, the severe misalignment of the U.S. dollar against foreign currencies, by magnifying our net export imbalance, is having a major destabilizing impact on growth rates as well as undermining the long-term vitality of U.S. manufacturing and agricultural sectors. I am encouraged by recent initiatives to provide better discipline and international coordination of national monetary and fiscal policies. I believe, however, that while the options to foster noninflationary growth are severely constrained, the Federal Open Market Committee cannot be indifferent to the international exchange value of the U.S. dollar.

DON RIEGLE.

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